DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 05-0328
Sales and Use Tax
For Tax Year 2001

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ISSUE

I. Sales and Use Tax—Manufacturing Exemption

Authority: *Mason Metals Company, Inc. v. Indiana Department of State Revenue*, 590 N.E.2d 672 (Ind. Tax 1992); *Miles, Inc. v. Indiana Department of State Revenue*, 659 N.E.2d 1158, 1163 (Ind. Tax 1995); IC § 6-2.5-5-5.1; IC § 6-2.5-5-6; IC § 6-2.5-5-20; 45 IAC 2.2-4-27; 45 IAC 2.2-5-8; 45 IAC 2.2-5-16

Taxpayer protests the assessment of sales and use tax.

II. Tax Administration—Negligence Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a manufacturing business in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for sales and use taxes. Due to the volume of purchases in the tax period, the Department used a sample and projection method to determine the sales and use taxes due. Taxpayer protests some of those assessments and claims that some of the items listed in the projection are exempt. Further facts will be supplied as required.

I. Sales and Use Tax—Manufacturing Exemption

DISCUSSION

Taxpayer protests the imposition of sales and use tax on several items it purchased during the tax years at issue. First, taxpayer protests the imposition of tax on safety supplies. Taxpayer refers to 45 IAC 2.2-5-8(c)(2)(F), which states:

> The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.
> …
> (F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.
> …

In its protest, taxpayer states that the Department's assessment included items of safety clothing or equipment which qualifies for the exemption found in 45 IAC 2.2-5-8(c)(2)(F). While the Department understands this argument, there is insufficient documentation in the protest file to support taxpayer's assertion that the equipment in question qualifies for the exemption found in 45 IAC 2.2-5-8(c)(2)(F).

Second, taxpayer protests that the Department charged sales tax on crane rentals. The crane lifted and placed taxpayer's product in specific locations at taxpayer's customer's sites. The Department referred to 45 IAC 2.2-4-27, which states:

> (a) In general, the gross receipts from renting or leasing tangible personal property are taxable. This regulation *[45 IAC 2.2]* only exempts from tax those transactions which would have been exempt in an equivalent sales transaction.
> (b) Every person engaged in the business of the rental or leasing of tangible personal property, other than a public utility, shall be deemed to be a retail merchant in respect thereto and such rental or leasing transaction shall constitute a retail transaction subject to the state gross retail tax on the amount of the actual receipts from such rental or leasing.
> (c) In general, the gross receipts from renting or leasing tangible personal property are subject to tax. The rental or leasing of tangible personal property constitutes a retail transaction, and every lessor is a retail merchant with respect to such transactions. The lessor must collect and remit the gross retail tax or use tax on the amount of actual receipts as agent for the state of Indiana. The tax is borne by the lessee, except when the lessee is otherwise exempt from taxation.
> (d) The rental or leasing of tangible personal property, by whatever means effected and irrespective of the terms employed by the parties to describe such transaction, is taxable.
> (1) Amount of actual receipts. The amount of actual receipts means the gross receipts from the rental or leasing of tangible personal property without any deduction whatever for expenses or costs incidental to the conduct of the

> business. The gross receipts include any consideration received from the exercise of an option contained in the rental of lease agreement; royalties paid, or agreed to be paid, either on a lump sum or other production basis, for use of tangible personal property; and any receipts held by the lessor which may at the time of their receipt or some future time be applied by the lessor as rentals.
> (2) Rental or lease period. For purposes of the imposition of the gross retail tax or use tax on rental or leasing transactions, each period for which a rental is payable shall be considered a complete transaction. In the case of a weekly rate, each week shall be considered a complete transaction. In the case of a continuing lease or contract, with or without a definite expiration date, where rental payments are to be made monthly or on some other periodic basis, each payment period shall be considered a completed transaction.
> (3) Renting or leasing property with an operator:
> (A) The renting or leasing of tangible personal property, together with the services of an operator shall be subject to the tax when control of the property is exercised by the lessee. Control is exercised when the lessee has exclusive use of the property, and the lessee has the right to direct the manner of the use of the property. If these conditions are present, control is deemed to be exercised even though it is not actually exercised.
> (B) The rental of tangible personal property together with an operator as part of a contract to perform a specific job in a manner to be determined by the owner of the property or the operator shall be considered the performance of a service rather than a rental or lease provided the lessee cannot exercise control over such property and operator.
> (C) When tangible personal property is rented or leased together with the service of an operator, the gross retail tax or use tax is imposed on the property rentals. The tax is not imposed upon the charges for the operator's services, provided such charges are separately stated on the invoice rendered by the lessor to the lessee.
> (D) Notwithstanding any other provision of this regulation *[45 IAC 2.2]* any lessee leasing or renting a vehicle(s) from any lessor, including an individual lessor, with or without operators, driver(s), or even if the operator (driver) himself is the lessor, regardless of control exercised, shall not be subject to the gross retail tax or use tax, if the leased or rented vehicle(s) are directly used in the rendering of public transportation.
> (4) Supplies furnished with leased property. A person engaged in the business of renting or leasing tangible personal property is considered the consumer of supplies, fuels, and other consumables which are furnished with the property which is rented or leased.

Taxpayer has provided documentation to establish that it did not own the cranes or employ the operators. However, 45 IAC 2.2-4-27(d)(3)(A) explains that control is exercised when the lessee has exclusive use of the property, and the lessee has the right to direct the manner in which the property is used. If these conditions are present, control is deemed to be exercised even though it is not actually exercised.

Taxpayer further refers to *Mason Metals Company, Inc. v. Indiana Department of State Revenue*, 590 N.E.2d 672 (Ind. Tax 1992) in support of its position. In that case, the court states:

> Mason contends its lease agreements do not accurately reflect the substance of its transactions with American. The substance, rather than the form, of transactions determines their tax consequences. See *Meridian Mortgage Co. v. State (1979), 395 N.E.2d 433, 440* (citing *Thompson v. Arnold (1958), 238 Ind. 177, 147 N.E.2d 903; Madding v. Indiana Dep't of State Revenue (1971), 149 Ind. App. 74, 270 N.E.2d 771*). Mason asserts the substance of its transactions with American involved the provision of transportation services and that American actually maintained possession and control over the tractor.
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> …
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> Indianapolis Transit addressed the question of whether chartering buses constituted lease transactions subject to sales and use tax. The court stated that whether a lessor/lessee relationship exists, subjecting a lessee to sales and use tax, is a factual question dependent on the lessee's possession and control over the leased property. Id. at 1209 (quoting *Thomas v. Foglio (1961), 225 Or. 540, 358 P.2d 1066*). The court analyzed whether the lessee had possession and control by considering six factors:
>
> (1) The employment of the driver.
> (2) The right to direct movement of the bus.
> (3) Obligation to pay costs and repairs.
> (4) Obligation to pay fuel costs.
> (5) The responsibility of garaging the vehicle.
> (6) Payment of insurance and license fees.
> Id. at 1209-10.
>
> In the case at bar, American maintained possession and control of the tractor, employed the driver, directed the movement of the tractor, n3 paid for repairs on the tractor, paid the fuel costs, and was responsible for garaging the vehicle. Although Mason paid for insurance on the tractor, American reimbursed Mason for such expense. In addition, the tractor was licensed in American's name. Accordingly, under the Indianapolis Transit test, Mason did not have possession and control of the tractor.
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> > n3 Arguably, Mason directed the movement of the tractor because Mason dictated the destination of its products. In the Indianapolis Transit case, the court recognized that under charter services passengers contracted with Indianapolis Transit System, Inc. (Indianapolis Transit), to take them to specific destinations. Indianapolis Transit, 356 N.E.2d at 1210. The court did not, however, find that Indianapolis Transit relinquished the right to direct the movement of its vehicles because the passengers had

> specific destinations. By analogy, the fact that Mason dictates the destination of its metal products does not imply that American relinquishes the right to direct the movement of its tractor. At trial Rod Memering, a plant manager of Mason, testified about the direction of movement:
> Q. Did [Mason] have any say or control in the route taken by the trucks in getting to the destination?
> A. No.
> (Id., at 674-5)

In this case, while taxpayer did hire the crane and operator to put the product in a specific place, the crane operator maintained control of the crane. As the court explained in Mason, this is the control to be considered under 45 IAC 2.2-4-27(d)(3)(A). Since taxpayer, as lessee, did not control the crane, the rental of the crane is not taxable under 45 IAC 2.2-4-27(d)(3)(A).

Third, taxpayer protests the imposition of use tax on its purchase of samples and promotional items of which the majority were shipped out of state. The Indiana Tax Court has explained the proper approach to this situation in *Miles, Inc. v. Indiana Department of State Revenue*, 659 N.E.2d 1158, 1163 (Ind. Tax 1995). In that case, the court explained:

> Miles argues that its promotional materials are excepted from use tax under the definition of "storage." "Storage" is defined as "the keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana." I.C. 6-2.5-3-1(*b*) (emphasis added).

The court determined:

> Miles is correct. This Court has previously held that the storage exception limits and qualifies the meaning of "use." USAir, Inc. v. Indiana Dep't of State Revenue (1993), Ind. Tax, 623 N.E.2d 466, 470. If property is stored in Indiana for subsequent use outside Indiana, then the activities of storing, handling, and transporting the property cannot be taxed as "uses." Id. To hold otherwise would subsume "storage" within "use," and nullify the exception for subsequent use outside Indiana. Id.
> The Court cannot presume the legislature intended to enact a nullity. Id. Therefore, the Court holds that the storage of the promotional items in, and the withdrawal of them from, Miles' Indiana warehouses for shipment out of state do not constitute taxable "uses," but rather fall under the storage exception in I.C. 6-2.5-3-1(b). Accordingly, the promotional materials at issue are not subject to use tax.
> (Id., at 1164)

Since some of the samples and promotional items were shipped out of Indiana, taxpayer is correct that those items should not be subject to sales and use tax, as explained in *Miles*.

Fourth, taxpayer protests the imposition of sales tax on steel straps. Taxpayer refers to 45 IAC 2.2-5-16, which states:

> (a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.
> (b) In general the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This regulation [45 IAC 2.2] provided an exemption for wrapping materials and containers.
> (c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:
> (1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.
> (2) Deposits for returnable containers received as an incident to a transaction of a retail merchant constituting selling at retail.
> (3) Returnable containers sold empty for refilling.
> (d) Application of general rule.
> (1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:
> (A) The purchaser must add contents to the containers purchased; and
> (B) The purchaser must sell the contents added.
> (2) Returnable containers sold at retail with contents. To qualify for this exemption, the returnable containers must be:
> (A) Sold in a taxable transaction of a retail merchant constituting selling at retail; and
> (B) Billed as a separate charge by the retail merchant to his customer. If there is a separate charge for such containers, the sale of the container is exempt from tax under this regulation [45 IAC 2.2].
> (3) Returnable containers sold empty. To qualify for this exemption the returnable container must be resold with the purpose of refilling. The sale of returnable containers to the original or first user thereof is taxable.
> (e) Definitions.
> (1) Returnable containers. As used in this regulation [45 IAC 2.2], the term returnable container means containers customarily returned by the buyer of the contents for reuse as containers.
> (2) Nonreturnable containers. As used in this regulation [45 IAC 2.2], the term "nonreturnable containers" means all containers which are not returnable containers.

Since 45 IAC 2.2-5-16(c)(1) provides an exemption for the steel straps used as enclosures for selling tangible personal property, taxpayer is correct that the steel straps are exempt.

Taxpayer also lists "Production Supply" as a protested item. The text of the protest contains no reference to "Production Supply." Taxpayer's argument is underdeveloped and will receive no further discussion.

In conclusion, there is insufficient documentation to support taxpayer's claim for the safety equipment exemption. The crane rentals are exempt as provided in *Mason Metals*. The percentage of samples and promotional items shipped out of Indiana are exempt. The steel straps are exempt as provided in 45 IAC 2.2-5-16(c)(1).

FINDING

Taxpayer's protest is sustained in part and denied in part.

II. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of penalty for the years in question. Taxpayer states that it had an error rate of less than one percent for overall purchase activity for the years in question. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

> If a person:
> …
> (3) incurs, upon examination by the department, a deficiency that is due to negligence;
> …
> the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full

> amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a new assessment which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). Taxpayer's reliance on its own calculation of a less than one percent error rate is not supported by statute or regulation. While taxpayer was correct on some of the items it protested in Issue I, taxpayer was incorrect on some of those items, and so did not prove that its failure to pay the assessments on those items was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

WL/BK/DK December 28, 2006